Value Based Management: approaching a dead end or a promising future?

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**Abstract**

This paper considers whether Value Based Management (VBM) has outstayed its welcome or has potential for future application. It reviews important debates over the value and future role of VBM as a tool of corporate strategic analysis and control. Key issues are whether established VBM has sufficient credibility as such a tool, whether the changing context of corporate analysis threatens it with being marginalised, and how new research ideas may extend and rejuvenate its application.
Background and development of VBM

What is meant by VBM?

VBM has been defined by many authors, but one distinguishing characteristic is its focus upon the principles of shareholder value. This was well brought out in a definition offered by KPMG:

‘…… a management approach which puts shareholder value creation at the centre of the company philosophy. The maximization of shareholder value directs company strategy, structure, and processes, it governs executive remuneration and dictates what measures are used to monitor performance.’

From personal practical experience, it has to be seen as a continuous process that requires much energy to sustain the momentum. This characteristic is brought out very clearly in a recent review article of VBM by Weaver and Watson, together with its process implications:

‘…VBM is a continuous process. It begins with strategic planning to achieve competitive advantages which produce superior growth in economic profits and returns to shareholders. Strategic planning guides the firm’s choice of a product-market scope and its resource requirements. The economic nature of the industry or industries in which the firm operates determines the patterns of its financial statements reflected in traditional financial ratio analysis. Based on a business economic analysis of the industry and the firm’s competitive position, projections of financial relationships provide a basis for valuation estimates. Since these are subject to error and change, further analysis based on identification of the key drivers of value are made. This facilitates study of the impact of operating performance on the value driver levels and the resulting valuations. Intrinsic value estimates are related to alternative performance measurements. Compensation systems should be linked to performance metrics. Periodic reviews lead to strategy revisions as well as to changes in policies and operations.’

Development of the approach

VBM as an approach to managing a business has developed over the past 15 or so years. Arnold and Davies trace this development, highlighting how VBM draws on a number of disciplines – finance, economics, human resource management – and the underpinning of the approach in well-known concepts of residual income, cost of capital and discounted cash flow. The approach has been used by many companies, among them Cadbury Schweppes, Boots, Lloyds TSB, and ABB, who have expressed their commitment to it. Consultants have been active in the development providing a number of alternative performance metrics from which companies can choose to implement the approach.
Alternative performance measurement metrics

This choice of metrics could be considered a major problem for anyone intent on pursuing VBM, for whilst the principles underpinning value creation seem to be straightforward, multiple methods of performance measurements are widely used in the literature. Arnold and Davies argue that this can lead to confusion, and raise issues such as: are some measurements more suitable in certain situations, organisations, industries than others? is there a case for consolidation? This leads potential users to a very reasonable question, ‘which one to use?’ Furthermore, will the differences among alternative measurements be such that the core principles of VBM will be pulled into different directions and thus rendered incoherent or unstable?

One attempt to answer this, by Weaver and Weston involves testing the relationships among four alternative financial accounting performance metrics set against market metrics on a historical basis as well as on a prospective basis. The four metrics are as follows:

1. Intrinsic value analysis/discounted cash flow valuation
2. Returns to shareholders
3. Economic profit, and
4. Market to book ratio

Comparisons of the strengths and limitations of each performance measure made use of an in-depth example. Data for Hershey Foods would enable comparisons and relationships to be quantified. The rationale for using Hershey was to relate and extend the analysis to the major reference text on the subject by Copeland et al., for which in the third edition, data for the company was used. Although illustrative calculations for different companies for different measures are acknowledged as being valuable, Weston and Weaver argue that by using one company alternative performance measures can be more directly compared.

As regards the specific methods, they were defined as follows:

Intrinsic Value Analysis
Two stage discounted cash analysis was applied to Hershey Foods for the seven year period 1994-2000. Stage 1 was an assumed period of competitive advantage during which the firm has favourable growth and profitability rates. Stage 2 was the terminal period beginning at the end of Stage 1 and continuing to infinity with lower growth rates and profitability. The enterprise operating value obtained from this analysis of Hershey was $9,430 million.

Returns to Shareholders
Returns to shareholders (RTS) are typically measured by calculating annual capital gains plus dividend yields. RTS is applied by using appropriate benchmarks, groups of firms, or indexes and as a performance metric, it compares the economic returns to investors in a firm relative to alternative benchmark investments.
The use of this RTS measure, argue Weaver and Weston, permits them to reach a reasonably firm conclusion, namely that Hershey’s performance was comparable to the broader industry segment of which it is a part. Further, it was superior to the broader S&P 500 index. They recognize that it would be useful to compare four or five firms with products more like Hershey’s, but there are no other major public chocolate and confectionary companies in the U.S.

Economic Profit Measures

Economic profit can be distinguished from accounting measures of net income for several reasons and not least because in its calculation a charge for the use of capital invested is deducted. This point has been explained before. As has also been noted, the consulting firm, Stern Stewart, has used the concept in a measure called economic value added whose abbreviation EVA® has been copyrighted. In applying the concept, Stern Stewart makes adjustments to NOPAT which also affect the measurement of the invested capital base. Adjustments to NOPAT seek to capitalize expenses such as R&D and advertising over the estimated lives during which they contribute to revenues.

A valuation of Hershey Foods using discounted economic profit as well as discounted cash flows was prepared by Weaver and Weston. The model used for this calculation was similar to the DCF calculation inasmuch as an explicit 10-year period was used, but they did not capitalize year 11’s cash flow as a perpetual residual value. By all accounts they extended the financial strategic plan into the future as far as 250 years! The resulting value is consistent with the enterprise operating value from DCF analysis, i.e. $9,430 million.

Market Valuation Ratios

The q (or Tobin’s q) ratio has been widely used to analyze the sources of differential firm efficiency related to variables such as diversification, percentage of equity ownership by top management, etc. In theory, the q ratio is defined as the market values of equity and debt divided by the current replacement value of assets. In practice, the denominator is difficult to calculate and as a consequence Weaver and Weston used more than one M/B measure, including the Whited (2001) approach that measures Tobin’s q as the ratio of the market value of assets divided by the book value of assets. This is equivalent to adding to the book value of assets the difference between the market and book value of equity and the denominator is therefore equivalent to the book values of equity plus debt.

Applying the q ratio as measured by Whited and the M/B ratio to the data obtained from the Hershey financial statements for 1980-2000 resulted in both ratios generally moving upward over the twenty year period.

* The rationale for using the Whited definition of the q ratio is that it is highly correlated with the other measures of q and does not require the complex estimates of the current replacement costs of investments.
In summary, Weaver and Weston found that the four alternative financial performance metrics are highly correlated. [Equivalently, the q ratio and market value added (MVA)].

They also found that standard financial ratio analysis as expressed in the DuPont formulation are also significantly related to market performance metrics and in the implementation of VBM.

Each of the performance measures has something to contribute argue Weaver and Weston; but each also has limitations. Their data for Hershey show that each provides information useful for increasing shareholder value. While some accounting measures are useful vehicles, because they underlie the intrinsic valuation of the firm, the ultimate tests are market based.

If it is concluded that each performance measure provides useful information, but also has limitations, the question might be posed, “since none of the measures is perfect what would you recommend as the performance metric of choice?” Their answer is to employ a multiple of performance measures to obtain a more complete and reliable assessment of performance; not a superior ranking of one metric over others, but a balanced judgement involving more than one.

It is recognised by Weaver and Weston that in theory the four alternative approaches to VBM which they analyze are somewhat different. However, their argument is that in practice, the implementations drawing upon their use have had similarities in methodology and coverage insofar as they all focus on strategic financial planning and ‘appear to make valuable contributions to performance improvement and to value creation.’

Research undertaken with three large companies, each of whom had adopted a different methodology, and who had been involved in implementing a shareholder value approach over a number of years, found significant similarity in their implementation approach.

Weaver and Weston conclude: ‘The empirical evidence argues for an eclectic approach to value based management. Intrinsic value DCF analysis, returns to shareholders or the shareholder scoreboard, economic value added, and the market-to-book analysis have all enhanced value. Each could contribute to effective information planning and control processes.’ (p26)

Limitations of the VBM approach

Issues in the use of VBM

Value Based Management (VBM) continues to attract attention, not all of it favourable. VBM as an approach to managing the business was reckoned by many to be a significant means for driving business performance. In recent times it has attracted attention from both those claiming that a substantial theoretical underpinnings is needed for it and those arguing
that it is time to move on. The first, as discussed above, is related to its application in measuring performance; the second is about whether overall it captures too narrow a concern with corporate performance in the current context of corporate analysis.

VBM has many unsettled issues in the literature, as Weaver and Weston and others point out (Martin and Petty, 2000; Rappaport, 1998; Stewart, 1991; Young and O’Byrne, 2001; Copeland et al, 2000), especially because of the alternative performance measurement theories. The formulation of different underlying theories is critical simply because VBM is driven by the principles of shareholder value and the approach assumes that management’s goal should be to maximise the market value of shareholder’s stake in a company. That is accepted financial/economic theory.

Thus:

“the company should make investment and financing decisions with the aim of maximising shareholder wealth”

But what is meant by value creation? Responses illustrate divergent or at least multi-faceted views as to the theoretical underpinning of VBM. From an external perspective, value creation is typically represented and measured by reference to total shareholder returns, i.e. increase in share price over time plus dividends. Internally, this is often translated into proxy measures, such as the need to produce returns on capital greater than the cost of capital. It follows that management’s task is to create value by earning returns on the capital which exceed the cost of capital. VBM is seen as a process of striving to achieve this target by managing the elements that create a company’s economic value, whether the elements are tangible or intangible. VBM thus provides a strategic perspective which includes a balance between the factors that promote short term performance with the longer term factors necessary for sustained competitive performance.

It would appear that no knock-out blow has been delivered against the analytical and practical utility of VBM in virtue of the fact that different performance metrics have been developed and are still applied. In fact we interpret the finding of Weaver and Weston in favourable, if cautious terms. Thus far the evidence suggests that the availability of different measurements in VBM does not vitiate the core concepts on which it rests and the basic strategic direction in which it points. Nevertheless we accept that this will be a matter of continuing debate and more research projects involving performance measurements rooted in VBM would fill important gaps.

Re-thinking the VBM process

It is evident that there is a case for better understanding of the theoretical underpinnings of VBM. However, what must also be contended with are views that claim a much more radical rethink of the whole issue. For example, von Mutius argues for:

‘…………a broader understanding of strategy and management that devotes greater attention to intangible values and quality factors, moving beyond the rigid, outdated
von Mutius put his view in a nutshell by saying that a strict management concept geared solely towards corporate value has probably passed its prime. He argues that its theoretical foundations are crumbling, and it is increasingly being eroded by external influences and what he refers to as its own inner contradictions. He acknowledges that the shareholder value model has had an impressive career but that more recently, dissenting views have gained in number and weight, criticizing its strategic narrow-mindedness, challenging its absolutist claims, and questioning its feasibility.

He does not contest that the fundamental objective of business is creating value (or increasing the share of equity in corporate value). Instead, he focuses on what he sees as one-sidedness and a lack of realism of a perspective that does not do justice to the multidimensional requirements of modern business management. In particular, he questions whether it is meaningful to squeeze a complex organization into a sub-complex (shareholder value) model — a very valid point. He argues for a deliberate combination of material ‘value orientation’ with intangible ‘values orientation’ — in defining corporate purpose and strategic orientation, and in designing management systems. He considers that it is high time to rethink the relationship between corporate value and corporate values in the context of what he refers to as ‘Balanced Values Management.’

In effect, von Mutius makes the case for what he refers to as thinking ‘the Other.’ He does not advocate the development of an entirely new model, but rather starting from existing insights and experiences to combine them in a new way on the level of strategic business management.

Perhaps this view could be extended to consider the need to rethink the management of key ‘intangibles’ in an organisation such as leadership and business relationships. As the use of a shareholder value model is going to be by people in an organisation, surely there is a need to ensure a sound alignment between the values, beliefs and behaviours of individuals who are the ‘management’ and their relationships with each other and other stakeholders, and the corporate culture of the organisation in terms of its values, structures and processes?

von Mutius raises some challenging points that would win some recognition from those involved with VBM implementation. The view that corporate performance should be measured by values other than those captured in VBM has an intuitive appeal in a society of diverse and competing values — especially to those who express concern about just and non-market determined distribution of gains or losses involving the wider society, or about the overall long-term good of a society and its public interests. However, from the perspective of the company that has embarked on a VBM programme and for which there is an ongoing need to develop and work within this programme, a reasonable question would be, ‘what evidence or practical insights are available to help us along the journey? In this regard, a study by Wallace might be of particular interest.’
**Enlightened Value Maximisation**

VBM, stakeholder theory, and a hybrid form of VBM called enlightened value maximization are discussed by Wallace. He attributes this hybrid to Jensen and argues that it blends the performance measurement attributes of traditional VBM with the strategic philosophy of stakeholder theory.\(^1\)

Wallace begins by identifying a key issue relating to the fundamental purpose of the organization. He recognizes the existence of two main views on what should constitute the primary goal of the firm. Those falling into the ranks of what we might call ‘economists’ tend to endorse value maximization and the precepts of what was discussed earlier with reference to VBM. The primary challenge to this is stakeholder theory for which the underlying rationale is that the corporation exists to benefit not just investors, but all its major constituencies – employers, customers, suppliers, the local community, minority rights groups, the government and public interest regulators, and selected professional and expert agencies or institutions - as well as shareholders. The term ‘constituencies’ in the UK context already implies a socio-political dimension that goes above or is at least different from the segment ‘shareholders’. In simple terms, the success of the company following the VBM approach would be assessed simply by its long-run return to shareholders, under stakeholder theory a company’s success would be judged by taking into account the contribution (or its damage to) to all of its shareholders.

Wallace reviews both of these approaches together with Jensen’s enlightened value maximization hybrid theory. Most importantly, he uses statistical analysis to investigate whether a broader focus on multiple stakeholders is necessarily inconsistent with the pursuit of long-term shareholder value.

A major challenge in undertaking such analysis is recognised by Wallace. Whilst determining whether a company has provided value for its shareholders is fairly straightforward, measuring the corporate contributions to other stakeholders as well as the effect of such contributions on the company’s market value, is much more difficult. He identifies reputation as being a good indicator of commitment to its stakeholders and illustrates that what evidence there is supports the view that financial success and value creation are not incompatible with stakeholder prosperity. That said, however, he identifies a straightforward causality issue, i.e. ‘is it a company’s reputation for treating stakeholders well that helps drive its market value to higher levels, or is it the financial success and value creation of the company that give it the wherewithal to invest in its stakeholder relationships?’

To disentangle cause-or-effect relationship between value creation and stakeholder benefits, Wallace sought to answer two questions from his study:

1. How are stakeholder benefits affected by changes in shareholder value?
2. How do changes in stakeholder benefits in turn affect shareholder value?

Wallace used the annual Fortune ranking of ‘America’s Most Admired Companies’ over the period 1996 – 2000 as a proxy for stakeholder benefits, and Standard & Poor’s Compustat
database to compute Market Value Added (MVA). His analysis of over 400 companies suggests that creating value is a prerequisite to enhancing stakeholder benefits. In other words, companies that fail to add value to their shareholders generally end up failing to provide for other stakeholders. Moreover, for those companies that have clearly underinvested in stakeholder relationships, further investment is likely to be a value-adding proposition. Wallace’s final words summarise our experience from substantial involvement in trying to help organizations improve their performance:

‘……companies generally do well by doing good – but at the same time, they must do well to be able to do good.’

Building on Wallace’s views should not companies be disclosing that they are ‘doing good’ in building their reputation? The need for improvements to corporate reporting has been raised by many. Last year the FTSE launched a new index, the FTSE4Good, to track the performance of socially responsible companies, and within the company law review in the UK it is envisaged that companies will be required to produce an Operating and Financial Review, the over-arching objective of which is:

“to provide a discussion and analysis of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them”

The recommendation is that this will require reporting beyond financial on a range of social, environmental, employment and community issues relevant to a company’s performance. An opportunity to demonstrate that they are ‘doing good’ – and managing for value?

Although Wallace’s findings bear out several long-standing anecdotal observations that stakeholder value and shareholder value can be reciprocally reinforcing, VBM is always likely to attract critical fire as narrowly based on presuppositions that give primacy to markets, profit-seeking and wealth-creation for investors. The hybrid model plainly rejects the radical Left-wing overthrow of these presuppositions. This means that the ‘hybrid’ model, whilst capturing the play of competing values, hardly demotes the primacy of VBM’s central purpose relating to maximising shareholder value. The hybrid model seeks accommodation to other values than those central to VBM, and must therefore make other stakeholder values ‘side-constraints’ upon the pursuit of shareholder value. Von Mutius’s ‘values orientation’ can be taken on board, but at some points may involve a conflict and trade-off against the pursuit of shareholder value. The long-standing and interesting question is how the competing values ought to be prioritised when more of one such value does not entail more of the others.

A closer critical scrutiny of Wallace’s claim illustrates why this subject is one for continuing debate. For one thing, groups’ perceptions of a company’s reputation may vary considerably with the type of issue each of them regards as salient; e.g. employment protection for one group, health concerns with product consumption for another, minority rights for one group, or child labour in less developed economies for yet another. For another thing, the fact that a company may gain the wherewithal to invest in stakeholder relationships is only a
necessary, not a sufficient, condition of stakeholder satisfaction: the resource availability is one factor, the actual delivery and to whom and how allocated is another. Given such a possible gap it is no surprise that the results of any opinion survey by a certain range of stakeholders that is broadly favourable to corporate shareholder value as well would be trashed by radical opinion as too ‘tame’ in its views of what should be delivered, e.g. nothing less than wholesale global redistribution of wealth, would say some anti-globalisation of capitalism campaigners. Finally, in the period 1996-2000 the general opinion of corporations may have been ascending to its zenith in the U.S., and subsequently high stakeholder standing may have declined in the light of scandals concerning fraud, false reporting, questionable accounting, tax evasion, and collusion, and the decline of share prices between March 2000 and January 2003.

Thus VBM is on shifting sands so far as is concerned the narrowness or breadth of concepts of corporate social responsibility (CSR), as well as how far market regulation by law ought to constrain the pursuit of shareholder value. The intensified debate of recent times over corporate social responsibility is about the constraints upon untrammelled delivery of value to shareholders; it is also about how those constraints may be converted into opportunities for value creation or about how observing CSR acknowledges the ultimate dependency of the shareholder-orientated firm upon the wider society’s acceptance of values supportive of VBM. But that VBM is the subject of a lively debate about shareholder value within the context of other values is evidence of its continuing conceptual pull, indeed indispensability, rather than of a decline into a moribund state. We would refer to an earlier statement by Mills and Weinstein of these issues, and consideration of the question, ‘Can the demands of stakeholder and shareholder models be reconciled only in certain political-cultural conditions and only when vital interests are defined in a particularly mutually supportive way? ’

Developments in the use of VBM

A key feature of VBM that was identified earlier is that it has the principles of shareholder value at its core. Typically, these principles are applied at the corporate or business unit level to show the potential for value creating strategies to improve performance and returns. Interestingly, these principles have recently been applied to the area of purchasing. Up to now it has been common to view purchasing as a relatively insignificant backwater that warrants relatively little attention. A report by Crichton et al. for the Future Purchasing Alliance goes a long way towards dispelling this underestimation.

The report provides insights about the profound impact that purchasing/procurement decisions can have upon the value of the business. It argues that purchasing and supplier management can be deployed as a strategic lever capable of maximising shareholder value. This is quite different from the tradition in purchasing which has typically seen it omitted from the value agenda. As such the authors argue the full potential of supplier contribution and the complete range of programmes for purchasing performance improvement have both not been properly evaluated.
Such a claim has been prefigured in the growing attention given to supply chain relationships as a strategic area, and in particular the value impact of best and less-than-best practice in outsourcing has been underscored in one particular internationally comparative study.\textsuperscript{17}

The report by Crichton et al. represents the conclusion of the first phase of a four-years research programme examining ways in which business-wide initiatives with third party suppliers can be properly aligned to maximising shareholder value. As such, it provides a good illustration that the principles supporting VBM have much to offer and that it is alive and kicking!

\textbf{Conclusion}

This paper has highlighted a number of issues, and raised a number of questions, related to the use of VBM as an approach to managing a business:

- Alternative performance measurement metrics
- Process/values/culture/implementation issues
- Balancing stakeholder interests
- Opportunities for reporting VBM issues

Arnold and Davies\textsuperscript{18} present their view of the contribution of VBM thus as:

“the main contribution VBM makes to the field of management is not the valuation numbers it produces but the rich insights revealed in the process of investigating and analysing the value potential of strategies, business and investments. The qualitative, subjective and motivational aspects that impinge on business success are highlighted by the use of value principles, and this is what makes VBM a vitally important business approach despite its current limitations”

VBM – or managing for value – is an evolving approach, still in its relative infancy, with opportunities for further development to enhance the benefits it can offer to combine financial and strategic management techniques to support the creation of sustainable competitive advantage.

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